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Volume 6 | Number 14 Article 1

7-14-1995

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Recommended Citation
Harl, Neil (1995) "Survival of a Lien in Bankruptcy," *Agricultural Law Digest*: Vol. 6 : No. 14 , Article 1.
Available at: http://lib.dr.iastate.edu/aglawdigest/vol6/iss14/1

Agricultural Law Digest

An Agricultural Law Press Publication | Volume 6, No. 14 | July 14, 1995

Editor: Robert P. Achenbach, Jr. | Contributing Editor Dr. Neil E. Harl, Esq. | ISSN 1051-2780

SURVIVAL OF A LIEN IN BANKRUPTCY

— by Neil E. Harl*

It is an article of faith in bankruptcy that secured creditors are entitled to priority[1] and the secured creditor's lien or security interest continues through the bankruptcy process and beyond to provide security for non performance. A 1995 decision by the Seventh Circuit Court of Appeals has raised new concerns as to whether a secured creditor's lien necessarily survives through the bankruptcy process.[2]

Background

In the Seventh Circuit decision, *Matter of Penrod*,[3] a lender in Indiana had extended $150,000 of credit to a hog farmer with a security interest in the hogs.[4] The security interest was properly perfected; at no point was a question raised about the validity of the security interest.[5]

About a year after the security interest was perfected, the borrower filed bankruptcy under Chapter 11.[6] At that point, $132,000 was owed on the loan.[7] The lender that had extended the credit and obtained a security interest in the animals duly filed a proof of claim on a timely basis.[8] The debtor did not object to the lender's claim and did not question the validity of the lender's security interest.[9]

About a year later, the debtor filed its plan of reorganization under Chapter 11.[10] The plan specified that the bank's claim would be paid in full over seven years with accrued interest at 11 percent and payments would be made in monthly installments.[11] The proposed reorganization plan, however, *was silent on the question of the survival of the lender's perfected security interest.*[12] The plan did not provide specifically for the survival of the perfected security interest nor did the plan specify that the security interest would be extinguished.[13] The court order approving the plan of reorganization was likewise silent as to the survival of the security interest.[14] Although it is not completely clear, the lender apparently believed that its security interest would survive bankruptcy and would continue to provide security for payments to be made under the plan. Thus, the lender did not object to the terms of the plan and did not raise a question about the terms of the court order confirming the plan.[15]

The problem

Shortly after the debtor's Chapter 11 plan was confirmed by the bankruptcy court, the debtor's hogs developed pseudorabies, a disease affecting the capacity of the animals to reproduce.[16] Females infected with the virus miscarry. The debtor proceeded to sell the animals for slaughter but did not remit the proceeds to the bank as required by the terms of the security agreement.[17] When the lender learned of the sale, a suit was filed to enforce the lender's claim to the proceeds based on the perfected security interest.[18] The debtor's response was that the pre-bankruptcy security interest of the lender in the livestock was extinguished under the Chapter 11 reorganization plan.[19] The debtor pointed to the plan which prescribed that the lender would be paid in full in monthly installments but did not continue the security interest.[20] The debtor took the offensive by seeking an injunction barring the lender from attempting to enforce its claim to the extent the lender was relying on the security interest.

The bankruptcy court agreed that the lender's security interest had been extinguished in the process.[21] The United States District Court affirmed the bankruptcy court on the issue.

On appeal to the Seventh Circuit Court of Appeal, the court examined the relevant section of the Bankruptcy Code, Section 1141(c).[22] Section 1141(c) provides that —

> "except as provided in the plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan is free and clear of all claims and interests of creditors...." [23]

The court noted that a lien is defined in the Bankruptcy Code as an interest in property[24] and a security interest under the Uniform Commercial Code is an interest in property.[25] Therefore, the court concluded, the language of Section 1141(c) applied to liens and security interests. The Court of Appeals then held that —

> "...unless the plan of reorganization, or the order confirming the plan, says that a lien is preserved, it is extinguished by the confirmation."[26]

The court explained that if a secured creditor participated in the plan of reorganization such as by filing a proof of claim and then having its collateral treated by the terms of the plan, the lien or security interest is extinguished if a plan of reorganization is confirmed which does not mention survival of the security interest.[27]

In the *Penrod* decision, the bottom line was that the lender continued to be entitled to payment under the confirmed plan of reorganization. However, the lender lost its security for non performance.

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Agricultural Law Digest is published by the Agricultural Law Press, P.O. Box 5444, Madison, WI 53705, bimonthly except June and December. Annual subscription $100.

Printed with soy ink on recycled paper by Accurate Business Service, Madison, WI.

Lesson for secured creditors

The message of *Penrod* is clear: if a secured creditor holds a perfected security interest in collateral, the creditor should be careful to review the disclosure statement and the proposed plan of reorganization, and the creditor should take steps to see that the plan provides specifically for continuation of the creditor's security interest in the collateral. An assurance in the plan that the secured creditor will be paid does not alone serve to preserve the security interest in the collateral. Liens and perfected security interests pass through bankruptcy unaffected unless the lien or security interest is brought into the bankruptcy proceeding and dealt with there.[28]

FOOTNOTES

1 See generally 13 Harl, *Agricultural Law* § 120.05[2] (1995); Harl, *Agricultural Law Manual* § 13.03[5] (1995).

2 See Matter of Penrod, 50 F.3d 459 (7th Cir. 1995).

3 *Id*.

4 *Id*.

5 *Id*.

6 11 U.S.C. § 1101. See Harl, *supra* n. 1, § 120.03[6]; Harl, *Agricultural Law Manual* § 13.03[3][b].

7 50 F.3d 459, 461 (7th Cir. 1995).

8 *Id*.

9 *Id*.

10 11 U.S.C. § 1121.

11 Matter of Penrod, *supra* n. 2.

12 *Id*.

13 *Id*.

14 *Id*.

15 *Id*.

16 *Id*.

17 *Id*.

18 *Id*.

19 *Id*.

20 *Id*.

21 Matter of Penrod, 169 B.R. 910 (Bankr. N.D. Ind. (1994).

22 11 U.S.C. § 1141(c).

23 *Id*.

24 11 U.S.C. § 101(37).

25 11 U.S.C. § 101(51).

26 50 F.3d 459, 463 (7th Cir. 1995).

27 *Id*.

28 50 F.3d 459, 463 (7th Cir. 1995).

NEW IOWA NUISANCE PROVISION

by Neil E. Harl

In 1995, the Iowa legislature adopted a provision which specifies that a livestock operation is not a nuisance unless it is proved by clear and convincing evidence that: (1) the operation unreasonably and continuously interferes with a person's enjoyment of their life or property; and (2) the injury was caused by the negligent operation of the facility. The legislation requires producers to have manure management plans which includes having adequate land for applying livestock waste. The 1995 law also imposes siting distances from residences, businesses, churches, schools and public areas. The maximum for new operations is 2,500 feet for operations with more than four million pounds of cattle and 1.25 million pounds of hogs and other livestock. The 1995 law allows for expansion of existing livestock facilities but the animal weight capacity cannot be more than doubled by the expansion and the capacity increased to more than 1.6 million pounds for cattle or 625,000 pounds for other animals. For livestock operations closer than the the minimum required separation, written waivers may be requested from neighbors. Such waivers can be recorded and become binding on subsequent owners. Cost sharing assistance of up to $1,500 is available for tree plantings around waste lagoons. **H.F. 519, Acts of Iowa General Assembly (1995)**.

Two features of the 1995 Iowa legislation merit comment. The first is that the most rational approach to dealing with the odor problem appears to be to encourage the parties to negotiate compensation. The waivers authorized by the legislation or easements could be vehicles for achieving that result. If the "base line" is zero or near zero odors, and that tends to reflect the anticipation of the parties, those suffering from odors often feel they have "lost" something from enduring any significant level of odor. Compensation may ease that concern. Moreover, paying compensation induces those building and managing facilities to locate the facility and to operate the facility in a manner to minimize the level of compensation required. In the extreme, those wanting to build or enlarge a facility could "buffer" the facility by owning substantial amounts of land around the facility and then renting the land to others, perhaps at reduced rental to reflect the presence of odors. The objective would be to minimize the level of odors at boundary lines. So long as odors do not create a public health problem, there seems to be little reason to prevent a market from developing in land subject to significant levels of odors.

The ground rules for negotiating compensation should be clearly understood. Establishing the compensation level annually is appealing in that the amount of compensation could be adjusted as odor levels change. But the facility owner with capital committed to the operation is vulnerable to an escalation in demands by those enduring the odors. On the other hand, setting the levels of compensation at a permanent level initially leaves those enduring the odors vulnerable as the facility management could be become indifferent as to the level of odors generated. Clearly, a mediation provision should be included in any approach emphasizing negotiation of payment levels.

The second comment on the 1995 legislation is that the emphasis is on the distance to the nearest residence, business or other facility. It is believed that, to be acceptable long term, an arrangement should be based on odor levels at the boundary lines rather than on the minimum distance to specified facilities. Few property owners want to see the opportunity foreclosed of building a residence or other improvement anywhere on their land.

One obstacle to a negotiation approach is the difficulty in measuring odor levels (and types). Technology may solve that problem as well as to reduce the intensity of odors generated by concentrated livestock operations.